BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE ARIZONA CORPORATION COMMISSION'S OWN MOTION TO ESTABLISH THE COMMISSION WATER TASK FORCE

Docket No. W-00000C-98-0153

RUCO'S EXCEPTIONS TO THE RECOMMENDED ORDER

In 1998, the Arizona Corporation Commission ("Commission") established a Water Task Force to address problems facing the water industry in Arizona. On October 28, 1999, the Commission's Utilities Division ("Staff") issued an Interim Report of the Water Task Force ("Report"). The Report discussed a number of problems faced by the industry, and the various solutions proposed by the Task Force members.

On September 28, 2000, Staff issued a proposed order, recommending that the Commission endorse certain policies and legislative changes that had been the subject of the Water Task Force's discussions. Where the Task Force members did not reach consensus on solutions, Staff's proposed order incorporates only Staff's recommendations, and makes no attempt to incorporate the opinions of Task Force participants that held differing views. RUCO files these exceptions to Staff's proposed order.

New CC&Ns

Staff recommends that new water companies applying for Certificates of Convenience and Necessity ("CC&Ns") be required to show, as a condition for obtaining a CC&N, that no existing water company will serve the requested service territory. Under Staff's proposal, a new CC&N applicant would be required to provide rejection letters from all three "Class A" water companies, at least five "Class B" companies (including the five geographically closest to the applicant), and all existing water companies within five miles of the requested service territory.

RUCO opposes such an absolute preference for existing water companies to serve new areas. A policy that always prefers an existing company over a new company provides no room for the Commission to exercise its discretion regarding who should provide service in currently unserved areas. Small or newly-formed water companies are not necessarily non-viable or unfit to provide public utility service, and existing companies are not necessarily more fit to provide water service than a new company. In addition, Staff's proposed "five mile" provision is arbitrary, as there has been no showing that companies more than five mile away could not provide service as efficiently as those closer.

Staff's plan also presents practical implementation problems. Companies that are not interested in new service territories may be reluctant to assert that disinterest in a rejection letter. Similarly, water companies within five miles of the proposed service area may be reluctant to provide a rejection letter, if it can even be determined which companies are within that boundary. Thus, obtaining the required rejection letters may be infeasible. Also, new applicants could circumvent the intent of the "rejection letter" requirement by seeking rejection letters only from those "Class B" companies that consistently reject proposals for new service territories, unless "geographically closest" is defined.

Instead of adopting Staff's proposal on this matter, RUCO believes that the Commission should evaluate a new company's financial, managerial and operational fitness on a case by case basis.

Staff also suggests setting initial rates to achieve break-even no later than the third year of operation. Staff proposes to base those rates on the applicant's projection of customer growth. Staff has failed to define "break-even," e.g., cash flow or operating income. RUCO believes that other parties (e.g., RUCO, Staff, Administrative Law Judges, Commissioners, developers, prospective customers, and others) may have valuable input into the growth projections. Further, implementing this condition would neither ensure nor even necessarily improve the likelihood that the target third-year break-even results would be achieved. RUCO, also, does not agree that year three is the appropriate break-even point.

Staff also proposes to condition CC&N issuances, transfers and extensions on total or substantial compliance with Arizona Department of Environmental Quality (ADEQ) requirements. "Substantial" compliance needs to be defined in an appropriate manner. RUCO supports requiring water companies to comply with ADEQ requirements, but recognizes that some latitude from total compliance may be appropriate in some circumstances. For example, a water company in complete compliance could acquire a company in non-compliance, resulting in the acquiring company no longer being in compliance and, accordingly, no longer eligible for the CC&N transfers or extensions. Also, a large company with many systems is statistically more likely to have a violation than a smaller company. Therefore, requiring complete compliance discriminates against large companies and is counter-productive in the effort to reduce the number of small, non-viable companies. RUCO is also concerned that this absolute condition provides ADEQ with significant authority over which companies are eligible for CC&N issuances, transfers and extensions. Instead, the Commission should exercise its discretion, rather than locking itself into an inflexible policy.

Staff proposes to work with the Arizona Department of Water Resources (ADWR) to establish tiered rate structures for new CC&Ns. This recommendation is unnecessary and misguided. The implication is that Staff does not work with ADWR and does not consider appropriate rate structures. There is no reason to believe that tiered rate structures are not currently given consideration by Staff or that tiered rate structures should be given special recognition or status. (See "Tiered Rates" below for further discussion).

Incentives for Consolidation (Acquisition Adjustments)

In its proposed order, Staff recommends that a policy statement should be developed that would allow the recognition of acquisition premiums in utility rates if certain conditions are met. RUCO opposed this recommendation in the Report and continues to oppose such a policy. While such a policy potentially could create incentives for the acquisition of smaller systems by larger and better run systems (one of the agreed upon goals of regulatory reform) it would at the same time create the incentive for sales transactions where both buyer and seller desired a high price, resulting in uneconomic transactions taking place, with ratepayers financing the windfall profits to utility owners. If the Commission desires to create incentives for the sale and transfer of smaller utilities, the incentive offered should be one that allows the Commission to retain control of the ratemaking implications. The acquisition policy proposed would relegate some of this control to the buyer and seller of utility property, allowing them to dictate the magnitude of the incentive through the sales price and effectively set their own rates through the sales price.

RUCO believes there are mechanisms other than the allowance of acquisition premiums that could be put in place to create incentives for the purchase of small water systems. In the Report RUCO suggested several mechanisms that would create incentives and at the same time ensure that ratepayers benefited from such incentives. RUCO recommends that the Commission explore these options in lieu of Staff's proposed acquisition premium policy.

Option 1 - Allowance of an incremental premium on the company's authorized rate of return. In light of the additional risks a purchasing utility takes on when acquiring a non-viable system, the Commission could authorize an additional rate of return. This option would create a monetary incentive for the acquisition of non-viable systems, yet unlike an acquisition adjustment, the authority to determine the appropriate level of the incentive would remain with the Commission.

Option 2 - An emergency surcharge mechanism that would allow the acquiring company to obtain upfront ratepayer funding of the capital investment necessary to make the acquired system viable. The lag between a company's outlay of cash for capital investments and the recognition of the investment in rates creates disincentives for acquisition of non-viable companies. This disincentive can be removed by creating a regulatory mechanism that would allow the estimated cost of the necessary improvements to be included in a rate surcharge and funded upfront by ratepayers. Once the improvements were completed, the estimated cost would be trued up to actual cost.

Option 3 - A deferral accounting order that would allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition. The amount ultimately recoverable would be determined in the context of a rate case.

Universal Service Fund

Staff is advocating the establishment of "Water Universal Service Fund" as an acceptable way to improve the financial capability of small water companies. This is not something that Staff ever discussed with the Task Force and represents an entirely unexamined issue. RUCO strongly opposes such a fund. Such a fund would require well-run utilities (and ultimately their ratepayers) to pay the cost of remediation of utilities from which they receive no benefit, and in many cases the need for remediation is due to negligence and/or poor management on the part of the utility. The principles upon which utility regulation are based preclude such bias and cross subsidization.

Future Test Years

The proposed order contains a recommendation by Staff that the use of future test years not be adopted, yet proposes that policies should be developed that would allow the ratemaking recognition of post-test year investment, revenues, and expenses. RUCO agrees that a future test year should not be adopted. However, RUCO opposes the formulation of a policy that predetermines the types of proforma adjustments that will or will not be allowed in individual rate cases. Each utility in every rate case has a unique set of circumstances which must be assessed in the context of the over all goal of regulation to set fair and reasonable rates. A "one-size-fits-all" policy will not allow the flexibity and consideration of individual circumstances that is necessary to achieve such a goal.

Hook-up Fees

Staff proposes that the Commission commence a rulemaking proceeding to implement a Generic Hook-up Fee policy "along the lines of Staff's proposal." RUCO agrees that working toward a recognized methodology for the use of hook-up fees is a desirable objective. However, comments from the Water Task Force members on this issue were limited and more discussion on this topic is needed.

The rule-making proceeding should be an open process not limited to consideration of treatment "along the lines of Staff's proposal." Such a guideline is vague and unnecessarily restricts the rule-making process from considering appropriate options. For example, hook-up fees may be appropriate to finance plant and equipment other than new wells and storage tanks, as was proposed by Staff. Further, RUCO does not agree with Staff's suggestion the hook-up fee pay for only part of the new plant in every situation. There may be instances where a hook-up fee that pays the entire cost for a component of plant is appropriate. Care must be used to ensure that the specific details of the generic hook-up fee rules do not unnecessarily limit or create other undesirable or unanticipated impacts.

Rate of Return Policy

Staff has proposed that the Commission initiate a rulemaking proceeding to implement Staff's rate of return policy. Staff's rate of return policy would allow companies to choose between "1) a generic rate of return (for C, D and E companies only); 2) setting rates based on an operating margin basis (i.e., no rate of return consideration); or 3) an individual rate of return (i.e., traditional rate making)." RUCO has no objection to the concepts expressed in Staff's three options, however RUCO believes that under option 2, the Commission would still be required to determine the company's fair value rate base and rate of return, even if that were not the sole factor on which the Commission ultimately based the company's rates. RUCO views option 2 as similar to the way the Commission has set rates for small water companies to date, and has no objection to continuing that process.

Main Extension Agreements

Staff has proposed adoption of a rule that requires each water company to submit a tariff detailing its standard Main Extension Agreement (MXA). RUCO agrees that the concept of establishing main extension agreements in the form of a tariff for each water company has merit. However, the rule-making proceeding should be an open process not limited to implementing Staff's proposed MXA policy. Staff's MXA policy is sketchy, ambiguous, and provides an inappropriate and insufficient basis for the rule-making proceeding.

Tiered Rates

Staff recommends that the Commission order Staff to consider tiered rate designs for all water company rate cases and that the tiers be design to encourage conservation. This recommendation inappropriately assumes that Staff does not consider tiered rates when appropriate and that tiered rate designs should receive special status or recognition. Staff and all other parties should consider all appropriate rate design structures in each case and recommend the one that is most appropriate in the circumstances. Currently, Staff is free to consider tiered rates in any instance, and it regularly proposes a tiered rate structure when it believes it is appropriate. There is no need for the Commission to express a preference for a particular rate design apart from the facts of a particular application.

There is no credible study that demonstrates that inverted tier rate designs inherently promote conservation. For regulated utilities, where there is a target revenue requirement, the notion that an inverted tier rate structure automatically encourages a reduction in consumption is contrary to economic theory. There is no study that supports the underlying assumption that the elasticity of demand for water is greater for large users than smaller users.

The widely recognized primary purpose of rate design is to align rates with the cost of service. Even where conservation is a major consideration, the relationship between price and cost of service generally remains the primary purpose of rates. Education and water audits are generally recognized as significant factors of conservation programs. There is no basis for using rate design as the primary conservation mechanism and it is ill advised.

Staff's proposed order includes a finding that "[i]f customers continued to use water in the third tier, the water company would probably overearn. The use of the overearnings could be restricted by the Commission in such a manner as to benefit the customers." (Finding of Fact No. 28). This provision is wrought with problems and ambiguities. Staff has not defined "over-earning," who would determine the amount of the over-earnings, or how the over-earnings would be treated. Allowing a company to over-earn also has implications regarding risk and return, regulatory monitoring and compliance costs, and inequities for utilities that are not granted this over-earning opportunity.

Rate design is one of the most important aspects of setting rates for public service corporations. A customer whose rates are excessive due to improper rate design is no less harmed than when a utility is allowed an excessive rate of return. Due to the complex nature of rate design and the many varying circumstances of water systems, a single methodology for designing rates is inappropriate. Ratepayers deserve properly designed rates based on appropriate consideration of all rate design criteria without prejudice toward any particular rate structure.

CAP Water

In its proposed order the Commission Staff is recommending that a policy be developed regarding the rate recoverability of CAP Water costs. Specifically, the Staff believes that a portion of CAP Water costs should be recoverable from ratepayers via a combination of tariffed rates and hook-up fees, regardless of whether the utility is using its CAP allocation. RUCO believes that the Staff's proposed policy is not in the public interest, and would create disincentives on the part of the water industry to promote the state's water policy goals. The mere retention of a CAP allocation without the actual use of CAP water provides no benefit to anyone. Utilities that are not using their allocations continue to pump water from the aquifer, and are not doing anything to replenish the amounts withdrawn. A CAP allocation is only worthwhile if a utility uses it in furtherance of the state water policy goals. The Commission's policy historically has been that if a utility is not using its allocation it cannot recover it through rates. Despite this policy of non-recovery, a large number of the private water companies that have had CAP allocations for over 10 years are still not utilizing the water. RUCO believes a change in the policy to allow recovery of these costs without actual utilization of CAP water will merely create further disincentives for such recalcitrant utilities to put their CAP allocations to use.

Development of policies

Staff proposes that it develop detailed policies by March 31, 2001 on water CC&Ns, acquisition adjustments and rate of return premiums, tiered rates and CAP cost recovery. Aside from RUCO's substantive concerns with some of Staff's proposals on these issues, RUCO believes that the deadline for development of detailed policies on these issues is unrealistic. These are issues of importance, and the Staff proposals on these policies vary significantly from current practices. Further, RUCO believes that the any detailed policies developed should be submitted to the Commission for approval before becoming effective.

Conclusion

The Commission can best address issues of fitness of new water companies, initial rates, incentives for consolidation, pro-forma adjustments and rate design on case by case bases. Any further proceedings to explore issues of hook-up fees or main extension agreements should consider all possible solutions, rather than just those proposed by Staff. Finally, the Commission should continue with its policy of denying recovery for CAP water costs until the water is actually put to use.

RESPECTFULLY SUBMITTED this 18th day of October, 2000.

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